Boston College Law Review

Volume 10
Issue 3 *A Symposium Federal Rule 23 - The Class Action*

Article 19

4-1-1969

Rule 10b-5 and the Control Premium: Duties of Disclosure and Invitation

Frances X. Hogan

RULE 10b-5 AND THE CONTROL PREMIUM: DUTIES OF DISCLOSURE AND INVITATION

I. *Ferraioli v. Cantor*[1]

In February, 1965, Denison Mines Ltd. was the controlling shareholder of General Baking Company. Denison owned 553,000 shares, one-third of all the General Baking stock, and was able to elect the General Baking president and several of its directors. The Goldfield Corporation was interested in purchasing a controlling interest in General Baking and negotiations to this effect were conducted with Denison between February 1 and May 13, 1965. The presidents of Denison and Goldfield agreed upon a tentative price of $12.50 per share, although the market price at the time was $9.00 per share. The $3.50 difference was a premium paid for control.[2] On May 10, Goldfield's board of directors approved the purchase of up to 665,000 shares from Denison at the $12.50 price. Between May 10 and May 13, the final terms were worked out and, on May 13, Denison sold 553,900 shares of General Baking stock to Goldfield at $12.50 per share, subject to the approval of Denison's board of directors. On the same day, "associates"[3] of Denison who owned General Baking stock sold 75,100 shares to Goldfield at the $12.50 price. The associates' shares brought the total of Goldfield's purchase to 629,000 shares. The approval of Denison's board of directors was given on May 17, and on that date a public announcement was made of the sale.

Anthony Ferraioli, the plaintiff, had owned 400 shares of General Baking stock which he sold on the open market on May 10 at $8 7/8 per share. Ferraioli brought an action under Section 10(b)[4] and Rule 10b-5[5] of the Securities Exchange Act of 1934 on behalf of himself and similarly situated former General Baking stockholders who sold their stock between February 1 and May 17. The plaintiffs alleged that the payment by Goldfield of a premium over market price for the shares purchased from Denison and its "associates" worked a fraud on the plaintiffs because they were not told of the negotiations in progress between Denison and Goldfield and were not

---

1 281 F. Supp. 354 (S.D.N.Y. 1967).

2 The court does not provide any basis for its assertion of this fact. The plaintiff attributes the $3.50 payment over the $9.00 market price as consideration for the transfer of control. Brief for Plaintiff at 4, Ferraioli v. Cantor, 281 F. Supp. 354 (S.D.N.Y. 1967).

3 The plaintiff has not been able to determine exactly who the "associates" were, since the sale was made through a trust company. Id. at 5-6.

4 15 U.S.C. § 78j(b) (1964).

5 17 C.F.R. § 240.10b-5 (1968) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

offered an opportunity to participate in the sale of General Baking stock at a premium. The plaintiffs alleged that since Denison made it possible for certain "associates" to participate in the sale of stock at a premium, all minority General Baking stockholders should have been offered the same opportunity.[6]

Defendants' motion for summary judgment was denied in a memorandum decision. The defendants then moved for reargument of their summary judgment motion, or, in the alternative, for a court order allowing them to appeal directly to the court of appeals. These motions were likewise denied. The court held that a claim is stated under Section 10(b) and Rule 10b-5 either where a controlling shareholder discloses to some, but not to all, minority shareholders, the existence of a purchaser's offer to pay a premium for a certain number of shares in addition to the controlling shares; or, where the controlling shareholder invites some, but not all, minority shareholders to participate in a sale of stock at a premium.

A summary judgment decision is not generally rendered on the complete facts of the case since it occurs before a trial on the merits.[7] The court, in response to a summary judgment motion, takes the allegations of the plaintiff as fact, and resolves reasonable uncertainties in favor of the plaintiff.[8] A denial of the motion gives notice of the existence of a genuine issue of material fact.[9] The opinion in *Ferraioli* does not make clear which allegations of fact were relied upon in the determination that a claim may be stated under 10b-5, nor does it make clear the precise nature of the 10b-5 claim which might be stated.

Because of the vagueness of the court's opinion, *Ferraioli* is susceptible of two interpretations. First, the court may simply have seen *Ferraioli* as another case where "insiders"[10] and "tippees"[11] traded on material information without proper disclosure. The court may have felt that the controlling shareholder informed certain associates that a purchaser was willing to pay a premium for more shares of stock than the controlling stockholder owned, and then, that the associates bought stock from the plaintiffs in the open market without disclosure of the availability of the premium. This interpretation of the opinion finds some support in the court's remark that it was not apparent under what circumstances the associates purchased their stock, or whether the controlling shareholder or any of his associates purchased stock in the open market with knowledge of the Goldfield offer.[12]

[6] Although the court states that the plaintiffs were seeking the premium on the entire 629,000 shares, the plaintiff's brief suggests that the recovery sought was only a "portion" of the premium. Brief for Plaintiff at 1-2, Ferraioli v. Cantor, 281 F. Supp. 354 (S.D.N.Y. 1967).

[7] Fed. R. Civ. P. 56(d).

[8] See Sartor v. Arkansas Natural Gas Corp., 321 U.S. 620, 628-29 (1944).

[9] See F. James, Civil Procedure 231 (1965).

[10] An "insider" is a person who has access to material information intended to be available only for a corporate purpose and not for the personal benefit of anyone. Ross v. Licht, 263 F. Supp. 395, 409 (S.D.N.Y. 1967).

[11] A "tippee" is a person who is given information in breach of trust by an insider and is subject to the same duties as an insider. Id. at 410.

[12] 281 F. Supp. at 358.

If the court felt that the plaintiffs could establish these facts at trial, it was correct in holding that a claim is stated under 10b-5. This is a common type of 10b-5 action, and is not particularly noteworthy.[13]

However, a second interpretation is possible. *Ferraioli* may have held that disclosure by the controlling stockholder to only a few of the minority stockholders that a premium was available for a certain number of shares in addition to the controlling shares, or that invitation of only some of the minority stockholders to join in such a premium, is a violation of 10b-5, even if none of the defendants had first augmented their holdings by buying shares from uninformed, uninvited minority shareholders. Although the opinion in *Ferraioli* is not entirely clear, the tenor of the decision as a whole supports this second, novel interpretation.[14] For the purposes of this comment, it shall be assumed that the second interpretation was intended by the court. The validity of that holding will then be analyzed in terms of the proper statement of a Rule 10b-5 claim. Since this interpretation reveals that two separate violations of 10b-5 may have occurred, a breach of a duty to disclose and breach of a duty to invite, this comment will examine each of these alleged violations separately and then determine the relationship between them.

II. The Duty To Disclose

The court found a violation of 10b-5 where a controlling stockholder, after being informed by the purchaser that he is willing to pay a premium for shares in excess of those owned by the controlling shareholder, gives this information to certain associates and thereby enables them to take advantage of the premium in the sale of their individual shares of stock. *Ferraioli* apparently requires that the controlling shareholder disclose the availability of a premium to all minority shareholders and not just to those chosen by the controlling shareholder.

Materiality or significance of the undisclosed information is a critical issue in the determination whether 10b-5 imposes a duty of disclosure.[15] "Fraud" and "deceit" require that a misrepresentation or non-disclosure relate to facts which are important to the plaintiff, as a reasonable man, rather than to merely collateral matters.[16] The material fact in the *Ferraioli* case is the availability of the premium for a certain number of shares in addition to the controlling shares. The plaintiff alleged, in effect, that if the availability of the premium had been disclosed to him, he would have taken advantage of the information by attempting to sell his stock at the premium.

---

[13] See, e.g., Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

[14] For example, the court states:

> [I]f Denison used material undisclosed information for its benefit or for the benefit of its "associates" or "tippees," plaintiff would be entitled to seek recovery under Section 10(b) and Rule 10b-5.

281 F. Supp. at 356. The court further states:

> [It is] sufficient to hold here that where a control stockholder invites some but not other stockholders to participate in the sale, a claim may be stated.

Id. at 357.

[15] See 3 L. Loss, Securities Regulation 1431 (2d ed. 1961).

[16] Id. See also W. Prosser, Handbook of the Law of Torts 734 (3d ed. 1964).

The availability of the premium meets the usual test for materiality. In general, the materiality of undisclosed facts turns on whether a plaintiff would have been influenced to act differently than he did act if the defendant had disclosed those facts to him.[17] In *Ferraioli,* the plaintiffs alleged that they would not have sold their stock at the market price if they had been told about the premium. Even if it could be proven conclusively that the plaintiffs would never have taken part in the premium, even with full disclosure, the availability of the premium would still be a material fact. Knowledge that a premium sale was taking place would have influenced the plaintiffs to act differently.

A reasonable investor would certainly be influenced to act differently if he knew that a $3.50 premium was available to certain minority shareholders. If the controlling shareholder told the plaintiffs that a premium was available for a certain number of shares above the controlling shares, but at the same time told them that he had already determined which of the minority stockholders would be allowed to join in such a premium, a reasonable investor's judgment could still be affected. The investor could go to the controlling stockholder and ask to be allowed to join in the premium, or could go directly to the purchaser and offer his additional shares for premium sale. If both these efforts were to fail, an investor might be alerted to the fact that state fiduciary law was being violated.[18] Thus, even if there is no apparent chance for the minority shareholder to join in the premium sale when disclosure is made, the availability of the premium is still material to him since he could reasonably decide to hold his shares and to approach either the controlling shareholder or the purchaser, or to pursue a remedy under state fiduciary law.

The establishment of a material fact is only one element of a 10b-5 claim. Before a plaintiff can recover, he must show that he stood in a relationship with the defendant which was within the protection of Rule 10b-5.[19] Even though the opinion in *Ferraioli* does not deal specifically with the relationship between the plaintiffs and defendants, this aspect of the case may be the most significant feature of the decision. The plaintiffs in *Ferraioli* sold their stock on the market at the time when the defendants were negotiating for the sale of stock at a premium. The defendants did not trade on the market; they traded among themselves. Thus, there were two distinct transactions: the

---

[17] List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965).

[18] It cannot be established conclusively under the limited facts presented in *Ferraioli* whether any state fiduciary law has been violated. It is possible that the "associates" were directors and, if so, they may have stood in a fiduciary relationship to the plaintiffs. See H. Henn, Handbook of the Law of Corporations 377-80 (1961). If the "associates" were directors, the plaintiffs may have an action based on the fact that directors must exercise

> unbiased judgment in the best interests of the corporation as a whole. Any attempt . . . to favor one intracorporate group to the detriment of another breaches such [fiduciary] duties to the corporation.

Id. at 380. It is also possible that the plaintiffs could bring an action against the controlling shareholder for breach of fiduciary duties even if no directors were in fact involved, since the controlling shareholder may have stood in a fiduciary relationship to the plaintiffs. See 3 L. Loss, supra note 15, at 1450. Cf. W. Fletcher, Private Corporations § 5811 (perm. ed. rev. repl. 1961).

[19] Cf. Fisher v. Kletz, 266 F. Supp. 180, 190-93 (S.D.N.Y. 1967).

plaintiffs sold stock to third parties on the open market, and the defendants bought and sold stock among themselves.

Although the courts have done away with a requirement of privity in a 10b-5 case,[20] the duty to disclose is usually limited to the situation where the plaintiffs and defendants dealt with each other, at least indirectly.[21] This requirement of some type of dealing between the plaintiffs and defendants probably results from the fact that the vast majority of the cases brought under 10b-5 have been instituted by persons who have been "defrauded" either in direct dealings with the defendant,[22] or in a more indirect situation where some connecting element is still present.[23] There have been very few cases where a plaintiff, who did not deal with the defendant in any ordinary manner, has brought an action under 10b-5. *Ferraioli,* then, is one of these rare cases.

Although there is no case with a relationship aspect similar to that in *Ferraioli,* there is at least one case providing some analogy. In *McManus v. Jessup & Moore Paper Co.*,[24] the plaintiffs alleged that the defendants, former directors and majority stockholders, violated 10b-5 by selling their holdings at a large premium without disclosing this information to the plaintiffs or offering the plaintiffs an opportunity to participate. The plaintiffs alleged also that the defendants made false and misleading statements with regard to the transaction. The defendants moved to dismiss on the grounds that the complaint on its face revealed no 10b-5 cause of action because, inter alia, none of the plaintiffs had been a party to the defendants' stock transactions, either as purchasers or sellers. The plaintiffs in this case were apparently still stockholders. The court denied the defendants' motion to dismiss, thereby implying that the relationship between the plaintiffs and the defendants was adequate even though the plaintiffs had not dealt with the defendants even indirectly.

In 1952, however, *Birnbaum v. Newport Steel Corp.*[25] was decided on similar facts. In that case, the court held that a 10b-5 plaintiff must be either a defrauded purchaser or seller of securities in order to maintain an action. The court in *Birnbaum* felt that 10b-5 was aimed "solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs. . . ."

Rule 10b-5 appears, if anything, to militate forcefully against a doctrine

---

20 Although it was once felt that at least "a semblance of privity" was necessary to maintain an action under 10b-5, see Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), no requirement of privity presently exists. See Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242, 249 (6th Cir. 1962).

21 Cf. A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5 § 8.5 (1968).

22 See, e.g., Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

23 See, e.g., Fisher v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967); List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965).

24 Civil No. 8015 (E.D. Pa. July 30, 1948), reported in 5 SEC Judicial Decisions 810 (1948).

25 193 F.2d 461 (2d Cir. 1952). *Birnbaum* was a derivative action.

as limiting as that enunciated in *Birnbaum*.[26] Even the court which decided *Birnbaum* now questions whether it is a viable decision.[27] If the defendants' conduct were fraudulent, the application of Rule 10b-5 to situations like that presented in *Birnbaum* would accord with the broad general purpose of investor protection underlying securities legislation.[28] At any rate *Ferraioli* can be distinguished from both *McManus* and *Birnbaum*, because in *Ferraioli* the plaintiffs were sellers, even though they did not sell to the defendants. It would seem that, if a plaintiff who neither bought nor sold securities may be protected by 10b-5, a plaintiff who has sold should certainly be protected.

Rule 10b-5 is broad enough to encompass the relationship between the plaintiffs and defendants in *Ferraioli*. If the plaintiffs were "defrauded" in the sense that the defendants withheld material information from the plaintiffs, and subsequently bought and sold on the basis of this material information, then the plaintiffs would bear the requisite relationship to the defendants because they were "defrauded" by "any person," "directly or indirectly," "in connection with the purchase or sale of any security."[29] The wording of Rule 10b-5 is extremely broad. The congressional purpose of section 10(b) favors broad application of the Rule itself.[30] Congress sought to assure an open and free market by complete disclosure of all material facts. "No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells."[31]

One recent major case provides additional support for the sufficiency of the relationship between the parties in *Ferraioli*. In *SEC v. Texas Gulf Sulphur Co.*,[32] the court, discussing the withholding of material information, felt that where

> a corporate purpose is . . . served by withholding the news of a material fact, those persons who are thus quite properly true to their corporate trust must not during the period of non-disclosure deal personally in the corporation's securities or give to outsiders confidential information not generally available to all the corporations' [*sic*] stockholders and to the public at large.[33]

The court in *Texas Gulf Sulphur* felt that the "investing public" should be effectively informed of material information before insider trading is begun.[34]

The defendants in *Ferraioli* did not buy or sell securities on the open

---

26 Lowenfels, The Demise of the *Birnbaum* Doctrine: A New Era for Rule 10b-5, 54 Va. L. Rev. 268, 275 (1968).

27 See Entel v. Allen, 270 F. Supp. 60, 70 (S.D.N.Y. 1967). See also Vine v. Beneficial Fin. Co., 374 F.2d 627, 635 (2d Cir. 1967); A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967).

28 Note, Civil Liability under Rule X-10b-5, 42 Va. L. Rev. 537, 570-71 (1956).

29 See note 5 supra.

30 Congress instructed the SEC to formulate a rule which would prohibit the use of "manipulative and deceptive" devices. See Securities Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1964).

31 H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934).

32 401 F.2d 833 (2d Cir. 1968).

33 Id. at 850 n.12.

34 Id. at 849.

market, and, under early interpretations of 10b-5, this fact might have been a barrier to a plaintiff who wished to maintain a 10b-5 claim.[35] However, there is no express language in the statute or the Rule which limits their scope to direct dealing in an organized market. Moreover, there are positive indications in the Exchange Act and in its legislative history which suggest that the scope of the statute extends to all transactions in securities, unless the contrary appears in a particular section.[36]

If a plaintiff is defrauded in the sense that he sold stock which he would not have sold had he known of certain material facts within the knowledge of the defendants, and if the defendants bought and sold securities on the basis of these facts, a cause of action is validly stated under 10b-5, whether or not the plaintiff sold his stock directly or indirectly to the defendants, or whether or not the defendants bought and sold securities on the open market or among themselves. Rule 10b-5 covers fraud connected with the purchase and sale of any security. It is not necessary for a violation of the Rule that the defendants either buy or sell to the plaintiffs.

The *Ferraioli* decision has, in effect, determined that Rule 10b-5 is broad enough to encompass the sale or purchase of securities by insiders even when the selling and the buying takes place solely among the insiders themselves. If the plaintiff is injured because he sold securities which he otherwise would not have sold if he had known of the material facts known to the insiders, then the plaintiff has a 10b-5 claim. However, the assessment of the plaintiff's damages presents problems—for example, whether the plaintiff's damages are too speculative and whether any limitation should be placed on the total amount of damages which all plaintiffs together can receive.[37] These two problems are closely related because a limitation on the total amount of damages which the plaintiffs can receive will make it less objectionable to grant speculative damages, since an upper limit may prevent clearly excessive recovery.

The injury to the plaintiffs from the breach of the defendants' duty to disclose is the loss of the opportunity to avail themselves of the premium which the purchaser was willing to pay for a certain number of minority shares. This loss is difficult to assess because of its conjectural nature; in effect, a determination must be made as to what might have been. It is by no means certain that any particular plaintiff would have actually received a premium in the sale of his stock.[38]

If the defendants had fulfilled completely their duty to disclose, the most the plaintiffs could possibly have received was the $3.50 premium on

---

[35] It has been argued that the reference in § 10(b) to the "public interest" implies that the section and the Rule are limited to the organized market. See 3 L. Loss, supra note 15, at 1466.

[36] Id. at 1467.

[37] There is not an abundance of precedent with respect to the proper measure of damages since a large percentage of the 10b-5 cases are settled out of court after a summary judgment motion by the defendants is denied. See generally A. Bromberg, supra note 21, §§ 9.1-.2; Comment, Remedies for Private Parties Under Rule 10b-5, 10 B.C. Ind. & Com. L. Rev. 337 (1969).

[38] For a discussion of the evils of granting speculative recovery, see Comment, supra note 37, at 343-44.

each share sold. It is probable, however, that each plaintiff would have received less, since with full disclosure of the availability of the premium more stock might have been offered than the purchaser was willing to buy. In such a situation, the purchaser probably would have bought pro rata from each willing shareholder, bought on a first-come basis, or bought more shares than originally intended at a lower premium. The total premium received by each selling minority shareholder would be reduced if proportionate buying took place or if the purchaser lowered the premium that he was willing to pay for the individual shares of stock.

Even though the damages are extremely conjectural, the plaintiffs should not be barred from *any* recovery because a limitation on the total amount of damages can prevent injustice to the defendants. Two theories for the limitation of damages are suggested by the facts of the *Ferraioli* case. First, each plaintiff could be allowed to recover only the $3.50 premium on each share sold during the period when disclosure should have been made. This theory recognizes that it was the defendants' breach of duty which resulted in damage to the plaintiffs in an undetermined amount, and since it was the defendants' misconduct which caused the difficulty in assessment, each plaintiff should be allowed to recover the full amount which he might have received.

A second formula for damages is to restrict the amount which all plaintiffs receive to the total number of shares which the purchaser was willing to buy multiplied by the $3.50 premium. This limitation of damages recognizes the fact that the total amount which the plaintiffs could have received had the defendants not breached their duty to disclose was limited by the number of shares which the purchaser desired.

It is suggested that the second alternative for the limitation of damages is the appropriate remedy in situations like *Ferraioli*. It is a definite and practical measurement. The total amount recovered will not exceed that amount which the associates received as a premium on the sale of their shares and the premium received by the controlling shareholder will not be attacked.[39] On the whole, a limitation on the plaintiffs' damages to an amount equal to the number of shares which the purchaser was willing to buy, multiplied by the $3.50 premium, complies as closely as possible with the statutory demand that the plaintiffs' damages be limited to "actual damages."[40]

III. The Duty of Invitation

The opinion of the court in *Ferraioli* indicates that disclosure is not always sufficient to avoid liability under 10b-5. If the controlling shareholder can choose who is to receive a premium on the sale of stock, he must invite all minority shareholders to participate in the premium sale if he invites any to

[39] It is clear that the controlling stockholder has the right to receive a premium in the sale of his personal holdings. For this reason, the plaintiffs must not be allowed to attack directly the controlling shareholder's premium. See Essex Universal Corp. v. Yates, 305 F.2d 572, 576 (2d Cir. 1962); H. Henn, supra note 18, at 384; Hill, The Sale of Controlling Shares, 70 Harv. L. Rev. 986 (1957).

[40] See § 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb (1964).

join.[41] The imposition of an affirmative duty to invite is apparently a unique interpretation of 10b-5. It remains to be determined whether 10b-5 is the proper vehicle for imposing such a duty.

The only ground on which the court could find a violation of 10b-5 in the defendants' failure to invite all minority stockholders was a determination that the defendants' actions worked a fraud on those not invited. Since the court implies that the duty to invite would obtain even if full and complete disclosure were made, it is apparent that the court's conception of "fraud" in this aspect of the *Ferraioli* case is unlike fraud in any ordinary sense. Although proof of common law fraud is not necessary to establish a 10b-5 case,[42] some type of false or misleading representation or non-disclosure is necessary.[43] It is difficult to comprehend how a discriminatory invitation like that in *Ferraioli* can be termed "fraud" even by the most liberal of definitions. The invitation involved neither misrepresentation nor non-disclosure.

The defendants' actions could be called "manipulative"[44] in the broad sense that the non-invitation of the plaintiffs had a direct effect on the price which the plaintiffs received for their stock. But this is an unsatisfactory classification of the defendants' actions, since there are an infinite number of factors which could affect the price that one receives for stock. Congress obviously did not intend that any maneuver which affects the value of another person's stock be classed as "manipulative" and therefore violative of 10b-5.[45] Only those actions which involve some form of deception are within the ambit of the Rule. Although the defendants' actions may be termed unfair, undesirable and discriminatory, they do not constitute "fraud" or "manipulation" so as to be actionable under 10b-5.

The court in *Ferraioli* was apparently attempting to further the broad congressional purpose of the securities laws, rather than trying to determine whether the defendants actually violated the statute and the Rule as finally enacted. In seeking to prevent undesirable discrimination, the court stretched 10b-5 too far and, as a result, the concept of "fraud" under the securities laws has been distorted.

Even if it is assumed that the court was correct in its determination that the defendants' non-invitation of the plaintiffs constituted a valid cause of action under 10b-5, many of the same problems discussed above regarding the

---

41 See 281 F. Supp. at 357.

42 Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962). See 3 L. Loss, supra note 15, at 1430-44.

43 Most courts and writers tacitly assume that the "fraud" of Rule 10b-5 necessarily involves either misrepresentation or nondisclosure. See, e.g., 3 L. Loss, supra note 15, at 1764.

44 Section 10(b) itself forbids "manipulative" or "deceptive" devices. See note 5 supra.

45 In a somewhat different situation, one court has said that the purpose of 10b-5 was not to "establish a scheme of investors' insurance." List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965). But see A.T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967), where the court states:

> Nor do we think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is "usually associated with the sale or purchase of securities." We believe that § 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities . . . .

defendants' breach of the duty to disclose are again apparent. Thus, it may be questioned whether the plaintiffs bear the requisite relationship to the defendants. If non-invitation does constitute fraud, however, the plaintiffs in *Ferraioli* did bear a relationship to the defendants sufficient to maintain a 10b-5 claim. The plaintiffs fell within the broad words of the Rule itself,[46] and recent cases have hinted that one who has neither bought nor sold securities may validly state a claim under 10b-5.[47] The plaintiffs in *Ferraioli* were sellers of securities, and if a fraud was worked upon them, there is no reason why they cannot bring a 10b-5 action.

In order to perfect his cause of action, a plaintiff must demonstrate that he has suffered damage caused by the defendants' violation of the Rule. Since the statute demands that plaintiffs' recovery be limited to "actual loss,"[48] it is obvious that difficulties arise in measurement of the "actual loss" of the plaintiffs in *Ferraioli.* In the non-invitation aspect of *Ferraioli,* it is a little more definite that at least some of the plaintiffs would have joined on the premium sale if the defendants had fulfilled their duty to invite all minority shareholders to join. But again, it is impossible to determine which plaintiffs would have joined, and whether pro rata sharing would have been necessary. It is suggested, therefore, that the same measure of damages would be appropriate in the non-invitation situation as was considered appropriate in the non-disclosure aspect of the case. The plaintiffs, as a group, should be allowed to recover only an amount equal to the total premium received by the associates. This limitation on the plaintiffs' damages ensures that the defendants will not be subject to an unfair or excessive recovery by the plaintiffs.[49]

IV. Conclusion

It has been argued that the court's decision that the defendants may have violated 10b-5 by disclosing to only some of the minority shareholders the fact of the availability of the premium is well grounded. However, it is felt that a holding that a controlling shareholder may have violated the Rule simply by failure to invite all minority shareholders when he invited some is excessive. These two aspects of the *Ferraioli* decision, the duty to disclose and the duty to invite, are interrelated to some extent. The apparent imposition of a duty to invite all minority shareholders to join in a premium sale of stock when any are invited reinforces the duty to disclose, because it makes the materiality of the availability of the premium more obvious. A reasonable investor would definitely be influenced to act differently if he were informed not only that a premium were available, but also that he had a right to join in the premium. Both aspects of the opinion forward the "equal opportunity" theory by attempting to put all minority shareholders in the same position with respect to an available premium.[50]

---

[46] The plaintiffs were defrauded by "any person," "directly or indirectly," "in connection with the purchase or sale of any security." See note 5 supra.

[47] See text accompanying notes 23-26 supra.

[48] See § 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb (1964).

[49] See text accompanying notes 37-40 supra.

[50] The "equal opportunity" theory was first espoused in Andrews, The Stockholder's Right to Equal Opportunity in the Sale of Shares, 78 Harv. L. Rev. 505 (1965). This

Because the duty to disclose and the duty to invite are so closely intertwined in *Ferraioli,* it could be argued that imposition of the duty to invite is not a distortion of 10b-5, since the imposition of this duty is necessary to realize the objectives for which the duty to disclose is imposed. However, it is submitted that regardless of the close relationship between these two issues of the *Ferraioli* case, the imposition of a duty to disclose is a valid interpretation of 10b-5, but that the imposition of a duty to invite is not. Full disclosure of all material facts is the object of 10b-5. A scheme to afford "equal opportunity" for all in the sale of stock is an unwarranted extension of the Rule. In no way may the non-invitation of the plaintiffs be termed "fraud." Although it could be said that the imposition of a duty to invite is the only means by which the availability of the premium can be made more material, the fact remains that the availability of the premium is material information standing alone and is therefore subject to disclosure rules without the duty to invite all minority shareholders to join in the premium sale of stock. The *Ferraioli* court was apparently trying to further a rule of "equal opportunity" rather than attempting to interpret Rule 10b-5 as it presently operates.

The implications of the *Ferraioli* decision are important for the securities industry. As a result of the opinion, sales of large blocs of stock might better be accomplished by one of three methods. First, and most probable, the controlling shareholder in the sale of his controlling shares will not deal with any of the minority. The controlling shareholder will inform prospective purchasers that they must deal directly with the minority if they desire to buy more shares than he has to sell. In this manner, the controlling shareholder will not be under either a duty to disclose or to invite.

Second, it is possible that the controlling shareholder will offer all minority shareholders the opportunity to participate pro rata in the premium sale of any shares which are to be sold in excess of the controlling stockholder's personal holdings. This alternative implies that the purchaser has told the controlling shareholder that he is interested in purchasing additional shares. According to *Ferraioli,* the controlling stockholder will be under a duty to disclose to all minority stockholders the availability of the premium if he tells any of the minority shareholders. If the purchaser requests the controlling shareholder to find the additional shares, *Ferraioli* imposes on the controlling shareholder a duty to invite all the minority shareholders to join in the premium if he invites even one.

Third, the sale of a large bloc of shares in a corporation may be accomplished through the use of the tender offer[51] by which a prospective purchaser indicates the number of shares he desires and the price he will pay. All shareholders, including the controlling shareholder, are invited to offer any shares which they wish to sell at that price.[52] If more shares are offered

---

theory was immediately criticized by other commentators. See, e.g., Javaras, Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews, 32 U. Chi. L. Rev. 420 (1965).

51 Cf. Andrews, supra note 50, at 516.

52 Unless the stockholder's holdings are included in the tender offer, this alternative would be substantially the same as the first alternative discussed above where a general offer was made for all shares in excess of those held by the controlling shareholder.

than the purchaser is willing to buy, he may buy either pro rata or on a first-come, first-served basis.

The implications of the *Ferraioli* decision concerning the imposition of a duty to invite are especially important for owners of family corporations. Often, the father owns the actual controlling shares of a corporation, while his wife and children own certain of the minority shares and other minority shares are widely held. If the father desires to sell out of the corporation, he will face problems with respect to the sale of the stock owned by his wife and children. If a purchaser is willing to buy more shares than those owned by the father, the father must disclose this fact to all minority shareholders. The father must also invite all minority shareholders to join in the premium sale, if he invites his family. In effect, the father must either invite all to share in the premium sale of stock, or sell his family's shares without the premium.[53] Perhaps *Ferraioli* can be avoided if the controlling shareholder purchases the shares held by his family. But it is unlikely that any such obvious avoidance of *Ferraioli*'s prohibitions will be permitted by the courts.

The *Ferraioli* decision offers a hint of further judicial development of Rule 10b-5 liability. The court expressly left undecided the question whether 10b-5 is violated when a controlling shareholder sells his personal stock at a premium without informing any of the minority shareholders.[54] The court did decide that the change of control may become a material fact subject to the disclosure rules when associates are invited to join in on the premium sale.[55] It is possible that in the future courts will find the fact of the change of control itself a material fact and will require disclosure at an early date.

The court's distortion of 10b-5 by the imposition of a duty to invite in certain situations may lead to further unwarranted development of the Rule. If a future court were to determine that the premium sale of controlling shares is a material fact, even without disclosure to some minority shareholders, a court might also feel that all minority shareholders should be invited to join in the premium sale of the controlling shares. However, it is unlikely that any court would stretch Rule 10b-5 farther than has *Ferraioli* with respect to the imposition of an affirmative duty to invite.

FRANCES X. HOGAN

---

53 At common law, a father in a similar situation was allowed not only to sell his family's shares at a premium, but also to suggest to the purchaser an appropriate price for the minority's shares. See Tryon v. Smith, 191 Ore. 172, 229 P.2d 251 (1951).

54 See 281 F. Supp. at 357.

55 Id. at 356.